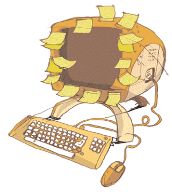
PAPER P3



Management Accounting – Risk and Control Strategy

Candidates must take more than the traditional accounting view of risk, control and internal audit. **The examiner for paper P3** uses a case study to explain why.

ABC is a small listed company in the service sector. Its board of directors takes its responsibilities to shareholders seriously. Over recent years it has tried to improve its corporate governance processes in the light of the Combined Code. The management prepares monthly accounts for the board and annual accounts for investors. The annual accounts are audited.

Although ABC's board takes overall responsibility for the company's accounts, it has delegated the detail of supervising the quality of the information and liaising with the external auditors to the audit committee. Two years ago the board established its first audit committee. In its first year, the committee focused on improving confidence in the company's financial statements and formed a view that ABC's internal financial controls were effective. Its view was supported by the external auditors, who considered the company's financial management and reporting to be sound.

ABC had an approach to internal control that allowed delegated decision-making within a framework of policies and financial regulations. It had made a lot of effort to recruit and train the best people, but the complexity of service provision and high staff turnover owing to industry competition meant that key work practices were documented as standard procedures and a quality management system had been introduced. Budgetary control was also quite strict.

The audit committee relied on a wide range of evidence in considering the effectiveness of ABC's internal controls. These included reports by external and internal auditors; management assurances about risk management and controls; the results of Inland Revenue and HM Customs & Excise inspections; the performance measurement system; the quality assurance system; the business planning and budgeting process; and contingency planning relating to the possible loss of information systems. The committee recognised that it had relied heavily on financial controls and was unsure whether the non-financial controls gave the board enough of an assurance that risk was being managed effectively.

A major form of internal control for ABC was its internal audit function. The company had thought for many years that it was more likely to achieve objective and cost-effective judgments about its internal controls by outsourcing this to a professional accounting firm.

Although the internal audit provided a lot of assurance about financial controls and the quality of financial statements, ABC's

WHAT DO EXTERNAL AUDITORS DO?

The main function of the external auditors is to form an opinion on a company's financial statements, focusing particularly on whether they give a true and fair view of the affairs of the business and have been properly prepared in accordance with the Companies Act 1989.

WHAT DOES THE AUDIT COMMITTEE DO?

The audit committee helps the board of directors to fulfil its stewardship duty by monitoring and reviewing the system of internal controls and risk management; internal and external audit; and the financial information provided to shareholders. It oversees the relationship between the external auditors and the company, assesses the effectiveness of these auditors every year and makes recommendations to the board concerning their appointment or removal.

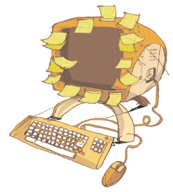
WHAT IS INTERNAL CONTROL?

Internal controls are the policies and procedures used by directors and managers to help ensure the effective and efficient conduct of the business; the safeguarding of assets; regulatory compliance; the prevention and detection of fraud and error; the accuracy and completeness of accounting records; and the timely preparation of reliable financial information.

These controls, along with the control environment, make up the internal control system. The control environment encompasses the attitudes of managers and directors on the significance of control. It covers the organisation's values, style, structure, responsibilities and competence. Internal controls are unlikely to be effective unless there is a supportive control environment.

WHAT INTERNAL CONTROLS DO FIRMS RELY ON?

Internal controls may be financial, such as variance analysis, stock recording systems and fixed asset registers, but a control system must look much further than that. Non-financial controls include numeric targets and performance indicators such as customer satisfaction, employee turnover and product wastage. These are quantitative controls because they involve numeric (although non-financial) measurement. But many controls are qualitative. They include policies and procedures; physical access controls; the structure of authority and reporting relationships; and a whole host of HR controls, such as employment contracts, job descriptions and performance appraisals.



WHAT ROLE DOES THE AUDIT COMMITTEE PLAY IN INTERNAL CONTROL?

The audit committee reviews the effectiveness of internal controls by assessing the significant risks facing the company and the effectiveness of its controls in managing them. This review covers financial, operational and compliance controls as well as risk management systems.

WHAT IS INTERNAL AUDIT?

An internal audit is an independent assurance and consulting activity designed to add value to an organisation's operations and help it to achieve its objectives by evaluating and improving the effectiveness of risk management, control and governance.

WHAT IS RISK MANAGEMENT?

Every organisation faces a number of risks of varying levels of seriousness. Risk can be seen both in terms of threat (something going wrong) and opportunity (achieving, or not achieving, business objectives). It can be financial (eg, incurring bad debts) or non-financial (eg, pollution), although most will be reflected in deteriorating financial performance sooner or later.

Risk management is concerned with identifying risks, assessing their likelihood and scale, and developing appropriate responses in the context of the organisation's appetite for risk. This may involve accepting some risks, while transferring others through insurance; treating them to reduce their potential impact; or controlling them. Risk management is also concerned with implementing and monitoring risk controls and reviewing their effectiveness.

WHAT IS A RISK REGISTER?

A risk register is a prioritised list of the main risks facing an organisation. Decisions are then made as to whether each risk will be accepted, transferred, or mitigated in some way. The register shows risk management actions and the allocation of responsibility to managers. It identifies both the gross risk (the impact before any control measures) and the net risk (after control actions are taken). This allows a cost/benefit comparison to be made in relation to each risk management action.

WHAT IS RISK-BASED INTERNAL AUDITING?

Risk-based internal auditing provides assurance to the board that risk management processes are operating as they should be, that management responses to risks are adequate and that controls are in place to mitigate risks. Internal audit focuses not only on financial risks, controls and reports, but also on the main business risks and the effectiveness of controls to manage them.

board became increasingly concerned with broader issues of control over the business operations. This was partly a reflection of the importance placed by the Turnbull report on risk management and its adoption into the Combined Code. As a result, it was decided that the remit of the audit committee should be extended to encompass risk management.

In the audit committee's second year of existence, ABC appointed a risk manager who implemented a comprehensive system of identifying and assessing risks, and of developing a risk register, which was reported regularly to the board.

Although the board was satisfied with the risk management processes that were in place, the audit committee felt that it didn't have a sufficient independent and objective assurance that the risk management system and internal controls were effective. The audit committee asked the internal audit provider to spend less time auditing financial systems and more time auditing the broader risk management system and internal controls – ie, to take a more risk-based internal audit approach.

Over the next year, ABC's audit committee became disillusioned with the internal audit provider, which had continued to take an overly traditional financial systems approach, rather than focusing on broader risk management issues. The committee considered that the major risk facing the company was a failure to achieve its business objectives, which could cause ABC to lose its market position in a competitive environment. The internal audit provider had failed to respond to these concerns, so the committee decided to put the work out to tender as a risk-based internal audit.

It soon appointed a new internal firm, which reviewed ABC's risk management system and recommended a new internal audit plan based on an assessment of the major risks. The risk register was improved and the audit committee received a higher level of assurance that controls were effective and that risks were being managed in accordance with ABC's appetite for risk. Financial controls remained important, but they no longer dominated internal audit, while many non-financial controls came to be seen as just as important as the financial ones.

Financial reports and systems are crucial for all organisations. But in ABC's case there were far more important risks facing the organisation and a need for controls beyond the traditional financial ones. Once an organisation has sound financial controls and can rely on its systems for timely and accurate financial reports, all risks need to be assessed – particularly those relating to the achievement of organisational objectives. Internal controls need to be put in place to manage those risks and a risk-based internal audit approach should support risk management and internal controls by providing assurances to the audit committee about their effectiveness. Only through a combination of risk management, internal controls, and internal and external audit can a board of directors fulfil its governance responsibilities. Focusing on accounting alone is simply not enough. FM